Office of Chief Counsel
Internal Revenue Service

memorandum

CC:NER:MAN:GL-503157-00
HJSchneck

date:

to: District Director, Manhattan District
Attn: Peter Salinger, Branch Chief, Team Division, Field Branch I

from: District Counsel, Manhattan District, New York

subject: **Request for Advisory**
Third Party Contact (Partnership Context)

UIL # 7602.04-01; 6223.00-00

This memorandum is in response to your inquiry of whether third party contact letters (Form 3164) must be sent to all partners of a partnership or only to general partners. Since this inquiry is general in nature, without any specific facts and circumstances, our response is limited to a general discussion of third party notice requirements involving the examination or collection of partnership items for a TEFRA partnership. Any inquiries that are factually specific should be directed to our office for additional advice. Based on the IRS Restructuring and Reform Act of 1998, and discussions with Attorney Bryan Camp and Technical Assistant Henry Schneiderman of the National Office, we believe that, in a case involving the examination or collection of partnership items, third party contact letters should only be sent to the partnership and the partnership's tax matters partner. In accordance with a conversation between Attorney Howard Schneck of our office and Henry Schneiderman, this memorandum will be forwarded to the National Office as 10 day Post Review Advice.

DISCLOSURE STATEMENT

This advice constitutes return information subject to I.R.C. § 6103. This advice contains confidential information subject to attorney-client and deliberative process privileges and if prepared in contemplation of litigation, subject to the attorney work product privilege. Accordingly, the Examination or Appeals recipient of this document may provide it only to those persons whose official tax administration duties with respect to this case require such disclosure. In no event may this document be provided to Examination, Appeals, or other persons beyond those specifically indicated in this statement. This advice may not be disclosed to taxpayers or their representatives.

This advice is not binding on Examination or Appeals and is not a final case determination. Such advice is advisory and does not resolve the Service's position on an issue or provide the basis for closing a case. The determination of the Service in the case is to be made through the exercise of the independent judgment of the office with jurisdiction over the case.

ISSUE

Who should receive notice of third party contacts (Form 3164) in a case involving the examination or collection of partnership items for a TEFRA partnership.

CONCLUSION

We believe that, in a case involving the examination or collection of partnership items for a TEFRA partnership, third party contact letters should only be sent to the partnership and the partnership's tax matters partner. However, the application of the notice provisions of I.R.C. § 7602(c) may significantly vary under different scenarios (i.e., when a partnership item ceases to be a partnership item). Therefore, we suggest that you forward any future inquiries that are factually specific to our office for additional advice.

DISCUSSION

BACKGROUND: I.R.C. § 7602(c)

Prior to the IRS Restructuring and Reform Act of 1998 ("RRA 98"), the Service was not required to give prior notice to a taxpayer of third party contacts made in connection with the examination of a taxpayer or the collection of tax owed by a taxpayer. RRA 98 amended Code Sec. 7602, which now requires the Service to provide reasonable advance notice to a taxpayer before contacting third parties with respect to examination or collection activities[1]. Specifically, I.R.C. § 7602(c) provides that:

> (1) An officer or employee of the Internal Revenue Service may not contact any person other than the taxpayer with respect to the determination or collection of the tax liability of such taxpayer without providing reasonable notice in advance to the taxpayer that contacts with persons other than the

[1] I.R.C. § 7602(c) applies to contacts made after the 180th day of the enactment of RRA 98 (i.e., after January 18, 1999).

taxpayer may be made.

(2) The Secretary shall periodically provide to a taxpayer a record of persons contacted during such period by the Secretary with respect to the determination or collection of the tax liability of such taxpayer. Such record shall also be provided upon request of the taxpayer.

(3) This subsection shall not apply -

(A) to any contact which the taxpayer has authorized,
(B) if the Secretary determines for good cause shown that such notice would jeopardize collection of any tax or such notice may involve reprisal against any person, or
(C) with respect to any pending criminal investigation.

The new law imposes three obligations upon the Service. First, the Service must give taxpayers a general warning at the beginning of the examination and collection process that the Service might contact third parties about the taxpayer's tax liabilities. I.R.C. § 7602(c)(1). Second, the Service must keep track of the third parties who are contacted. I.R.C. § 7602(c)(2). Third, the Service must provide that information periodically to the taxpayer as well as be prepared to release it whenever the taxpayer may ask[2]. Id.

Congress believed that this legislation would address the perceived harm to taxpayers' business relationships and reputations caused by IRS third party contacts. See, S. Rep. No. 105-174, at 77 (1998). By giving taxpayers advance notice, taxpayers will have the opportunity to provide the Service with information which may, in turn, reduce or eliminate the need for the Service to contact third party record-keepers. In addition, taxpayers will be able to minimize any potential damage to their business relationships and reputations by informing third parties about potential future contact by the Service. Id.

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[2] The Service does not have to release the information to taxpayers if the contacts are made in the course of a criminal investigation or if the Service either determines that releasing the information would jeopardize the collection or assessment of the liability or determines that such release would subject the third parties to reprisal. I.R.C. § 7602(c)(3)(B), (C).

However, as discussed below, in applying I.R.C. § 7602(c) in the partnership context, the Service must balance the taxpayer's concerns regarding the protection of his business interests and reputation against the privacy rights of the third parties and the Service's operational needs.

APPLICATION OF I.R.C. § 7602(c) TO TEFRA PARTNERSHIPS AND PARTNERSHIP ITEMS[3]

Background: TEFRA

Prior to the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), any examination and resulting adjustment in the treatment of partnership items was accomplished at the partner level, rather than at the partnership level. Klein v. United States, 86 F. Supp. 2d 690, 692 (E.D. Mich. 1999). The Service was required to audit each partner's return separately and its determination as to the treatment of a partnership item for one partner was not conclusive for any other partner. Id.

I.R.C. §§ 6221 through 6233 were added to the Internal Revenue Code with the enactment of TEFRA. I.R.C. § 6221 provides that all adjustments to partnership items are determined in a single proceeding at the partnership level, rather than at the partner level. A "partnership item" is any item required to be taken into account for the partnership's taxable year to the extent the regulations provide that such item is more appropriately determined at the partnership level rather than at the partner level. I.R.C. § 6231(a)(3). Those items constituting partnership items are set forth in Treas. Reg. § 301.6231(a)(3)-1.

A "non-partnership item" is an item that is either not a partnership item or ceases to be a partnership item under circumstances identified in I.R.C. § 6231(b). For example, once a partner enters into a settlement agreement that is executed by the Service, settled partnership items become non-partnership items. I.R.C. § 6231(b)(1)(C).

When the partnership is audited, the Service will generally deal with one partner -- the Tax Matters Partner ("TMP")--, but

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[3] This memorandum only addresses the examination of a partnership item or the collection of a partnership asset. Our advice may significantly differ for non-partnership items. Therefore, because of the different factual scenarios that may arise in connection with non-partnership items, specific cases should be referred to our office for advice as they arise.

other partners are entitled to participate fully in audit and appellate conferences. I.R.C. §§ 6223(g) and 6231(a)(7). Generally, the TMP is the general partner designated by the partnership to represent the partnership in all proceedings before the Service and the courts. Id. Under the TEFRA partnership provisions, otherwise specified, notice to the TMP has generally been held to be adequate notice to other non-notice partners. Walthall v. United States, 131 F.3d 1289 (9th Cir. 1997).

A "notice partner" is defined as any identified partner entitled to receive notice directly from the Service of the beginning of a partnership proceeding ("NBAP") and of the final partnership administrative adjustment ("FPAA"). I.R.C. § 6231(a)(8). Subject to certain exceptions, partners must receive the NBAP and FPAA from the TMP. I.R.C. § 6223(g). In partnerships with 100 or fewer partners, every identified partner is a notice partner. I.R.C. § 6223(a). However, in partnerships with more than 100 partners, a notice partner is any identified partner having a 1% or more profits interest or a member of a notice group consisting of a group of partners with a combined interest in the profits of 5% or more. I.R.C. § 6223(b).

Who Is The "Taxpayer" In a Case Involving the Examination Or Collection of Partnership Items For A TEFRA Partnership For Purposes of I.R.C. § 7602(c)

In determining the proper recipient(s) of I.R.C. 7602(c) third party contacts letters in a case involving the examination or collection of partnership items for a TEFRA partnership, it is necessary to first identify whether the term "taxpayer" under I.R.C. § 7602 relates to the partnership or the individual partners. I.R.C. § 7701(a)(14) defines the term "taxpayer" as "any person subject to any internal revenue tax." I.R.C. § 7701(a)(1) defines the term "person" as "an individual, a trust, estate, partnership, association, company or corporation." Therefore, based on the foregoing definitions, a partnership is a person that qualifies as a taxpayer under I.R.C. § 7701(a)(1).

Case law also supports the treatment of a partnership as a separate taxpayer. In Holloman v. Commissioner, 551 F.2d 987, 990 (5th Cir. 1977), a case involving whether a partnership or the individual partners were entitled to an investment tax credit, the Fifth Circuit agreed with the Tax Court that a partnership "is to be treated as an entity as distinguished from the individual partners, thereby giving effect to the definition of "person" contained in section 7701(a)(1) . . . ." The treatment of partnerships as separate entities is also apparent in Bergford v. Commissioner, 12 F.3d 166 (9th Cir. 1993). In

Bergford, the Ninth Circuit held that the Tax Court lacked jurisdiction over petitions filed by individual partners because notices of deficiency issued by the Service adjusted partnership items that are subject to review only in a partnership proceeding. Id. at 170. Likewise, it follows that for purposes of I.R.C. § 7602(c), when dealing with the examination of partnership items or collection of partnership assets for a TEFRA partnership, the partnership is considered the taxpayer, not the individual partners. Accordingly, notice of third party contacts in connection with the examination or collection of tax owed by a TEFRA partnership should only be sent to the partnership and the partnership's TMP, who is the statutory representative of the partnership. It is then within the discretion of the TMP pursuant to I.R.C. § 6223(g) and the regulations thereunder, to inform the other partners.

Even though the examination or collection of partnership items of a TEFRA partnership may ultimately affect the tax liability of the individual partners, the individual partners' tax liabilities are not the subject of the examination or collection of partnership items of a TEFRA partnership. In a case involving the examination or collection of partnership items of a TEFRA partnership, the tax treatment of partnership items is what is at issue and is determined at the partnership level. I.R.C. § 6221. Accordingly, it would be unusual for the Service to make third party inquiries regarding individual partners or investors.

Furthermore, individual partners are generally not in the best position to provide the Service with information in connection with the determination or collection of a TEFRA partnership's tax liability. To the extent that a partner has such information, the partner would most likely be an employee of the partnership or actively involved in the daily conduct of the partnership's business. Under such circumstances, notice to the partnership should be sufficient to provide notice to the partner/employee as well. Therefore, in balancing the interests of the parties, the partnership is more likely to have its reputation and business relationships potentially harmed by third party contacts, as opposed to the reputation and interests of the individual partners or employees. As such, providing notice to individual partners does not further the legislative intent of I.R.C. § 7602(c), as stated above.

Administrative Concerns

In addition, we believe that, in applying I.R.C. § 7602(c), the interests of taxpayers in protecting their reputations and business interests must be balanced against the Service's

operational needs to effectively administer the internal revenue laws. This balancing approach supports our position that notice of third party contacts when dealing with a TEFRA partnership should only be sent to the partnership and the partnership's TMP. Otherwise, providing notice to limited partners would become burdensome, particularly if there are a large number of partners.

We also believe that it is too administratively difficult to distinguish among the interests of certain classes of partners in determining which partners may be entitled to notice under I.R.C. § 7602(c). Since all partners may have an interest in protecting against potential damage to their reputations from IRS third party contacts, it would be inappropriate for the Service to give notice to some partners, but not others.

Although the TEFRA notice provisions of I.R.C. § 6223 may reduce some of the administrative difficulties in partnership examinations by designating certain partners as "notice partners," these provisions only apply to the issuance of notice of the beginning of a partnership proceeding ("NBAP") and of the final partnership administrative adjustment ("FPAA"). I.R.C. § 6231(a)(8). Also, it would be burdensome and administratively unwieldy to provide third party contact letters to all I.R.C. § 6223 notice partners before making each separate third party contact. In addition, using the notice provisions of I.R.C. § 6223 for notice of third party contacts would set an unwanted precedent for expanding the TEFRA notice provisions beyond their intended scope and purpose.

On the other hand, if certain partnership items cease to be partnership items or directly relate to the tax liability of individual partners, then those partners should be treated as separate taxpayers entitled to notice under I.R.C. § 7602(c). For example, if the Service mails notice to a partner pursuant to I.R.C. § 6231(b)(1)(A) that it intends to treat certain items as non-partnership items, it follows that the Service may be required to provide notice of third party contacts to the affected partner. In this case, the partner is now the "taxpayer," not the partnership. Also, since individual partners are more likely to have information relating to items that directly affect their own tax liability, providing notice to individual partners regarding non-partnership items comports with the legislative intent of I.R.C. § 7602 to give taxpayers the opportunity to provide the Service with information before contacting third parties. However, as previously stated, the application of the notice provisions of I.R.C. § 7602(c) may significantly vary under different scenarios and we suggest that you forward any future inquiries that are factually specific to our office for additional advice.

If you have any questions about any of the foregoing, please contact Attorney Howard J. Schneck of this office at (212) 264-1595 ext. 265.

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